

1                   **GOVERNMENT OF THE DISTRICT OF COLUMBIA**  
2                   **DEPARTMENT OF INSURANCE AND SECURITIES REGULATION**

3 **IN THE MATTER OF**                   )

4 **MORGAN STANLEY & CO.**                   )  
5 **INCORPORATED,**                   )

6                   **RESPONDENT.**                   )

**ADMINISTRATIVE CONSENT ORDER**  
                  **SEC. CO 03-05**

7                   **ADMINISTRATIVE CONSENT ORDER**

8                   WHEREAS, Morgan Stanley & Co. Incorporated ("Morgan Stanley") is a broker-dealer  
9 registered in the District of Columbia; and

10                  WHEREAS, coordinated investigations into Morgan Stanley's practices, procedures and  
11 conduct respecting the preparation and issuance by Morgan Stanley's U.S. equity research analysts  
12 ("research analysts") of research, analysis, ratings, recommendations and communications  
13 concerning common stocks of publicly traded companies covered by such analysts ("research  
14 coverage"), during the period 1999 through 2001, including without limitation, commencement and  
15 discontinuance of research coverage, actual or potential conflicts of interests affecting research  
16 coverage, research analysts or termination of research analysts, and statements, opinions,  
17 representations or non-disclosure of material facts in research coverage (the "investigations") have  
18 been conducted by a multi-state task force and a joint task force of the U.S. Securities and  
19 Exchange Commission, the New York Stock Exchange, and the National Association of Securities  
20 Dealers (collectively, the "regulators"); and

21                  WHEREAS, Morgan Stanley has cooperated with regulators conducting the investigations  
22 by responding to inquiries, providing documentary evidence and other materials, and providing  
23 regulators with access to facts relating to the investigations; and

24                  WHEREAS, Morgan Stanley has advised regulators of its agreement to resolve the  
25 investigations; and

26                  WHEREAS, Morgan Stanley agrees to implement certain changes with respect to its

1 research practices and stock allocation, and to make certain payments; and

2 WHEREAS, Morgan Stanley elects to permanently waive any right to a hearing and appeal  
3 under D.C. Official Code § 31-5606.02 (b) (2001 ed.) with respect to this Administrative Consent  
4 Order (the "Order");

5 NOW, THEREFORE, the Commissioner of the Department of Insurance and Securities  
6 Regulation, as administrator of the Securities Act of 2000, D.C. Official Code § 31-5601.01 *et seq.*  
7 (2001 Ed.), hereby enters this Order:

8 **I.**

9 Morgan Stanley admits the jurisdiction of District of Columbia Department of Insurance  
10 and Securities Regulation, neither admits nor denies the Findings of Fact and Conclusions of Law  
11 contained in this Order, and consents to the entry of this Order by the Commissioner of the  
12 Department of Insurance and Securities Regulation.

13 **FINDINGS OF FACT**

14 1. Morgan Stanley is, and was at all relevant times, a Delaware corporation and a registered  
15 broker-dealer with its principal place of business located at 1585 Broadway, New York, New York  
16 10036. Morgan Stanley is, and has been at all relevant times, an international financial services  
17 firm that provides investment banking services to businesses, engages in retail and institutional  
18 sales to its customers, and publishes research reports and ratings on stocks. In mid-2002, Morgan  
19 Stanley had about 58,000 employees with 700 offices in twenty-eight countries. It had  
20 approximately \$450 billion in assets under management as of May 31, 2002.

21 2. The Commissioner of the Department of Insurance and Securities Regulation has  
22 jurisdiction over this matter pursuant to D.C. Official Code § 31-5606.01 (2001 Ed.).

23 3. From at least July 1999 through 2001, Morgan Stanley engaged in acts and practices that  
24 created conflicts of interest for its research analysts with respect to investment banking activities  
25 and considerations. Morgan Stanley failed to manage those conflicts in an adequate or appropriate  
26 manner. Some conflicts resulted from the fact that Morgan Stanley compensated its research  
analysts, in part, based on the degree to which they helped generate investment banking business

1 for Morgan Stanley. Morgan Stanley also offered research coverage by its analysts as a marketing  
2 tool to gain investment banking business. As a result, Morgan Stanley research analysts were  
3 faced with a conflict of interest between helping generate investment banking business for Morgan  
4 Stanley and their responsibilities to publish objective research reports that, if unfavorable to actual  
5 or potential banking clients, could prevent Morgan Stanley from winning that banking business.

6 4. As lead underwriter in various stock offerings, Morgan Stanley also complied with the  
7 issuers' directives to pay portions of the underwriting fees to other broker-dealers that served as  
8 underwriters or syndicate members to publish research reports on the issuer. Morgan Stanley did  
9 not take steps to ensure that these broker-dealers disclosed these payments in their research reports.  
10 Further, Morgan Stanley did not cause the payments to be disclosed in the offering documents or  
11 elsewhere as being for research.

12 5. Morgan Stanley also failed reasonably to supervise its analysts regarding the content of  
13 their research reports.

#### 14 **I. 1. BACKGROUND**

##### 15 **A. The Investment Banking Function at Morgan Stanley**

16 6. The investment banking division at Morgan Stanley advised corporate clients and helped  
17 them execute various financial transactions, including the issuance of stock and other securities.  
18 Morgan Stanley frequently served as the lead underwriter in initial public offerings ("IPOs") -- the  
19 first public issuance of stock of a company that has not previously been publicly traded -- and  
20 follow-on offerings of securities.

21 7. During the relevant period, investment banking was an important source of revenues and  
22 profits for Morgan Stanley. In 2000, investment banking generated more than \$4.8 billion in  
23 revenues, or approximately twenty-four percent of Morgan Stanley's total net revenues.

##### 24 **B. The Role of Research Analysts at Morgan Stanley**

25 8. Research analysts at Morgan Stanley covered a broad range of industry sectors and  
26 published periodic reports on certain companies within those sectors. Analysts typically reviewed

the performance of their covered companies, evaluated their business prospects, and provided analysis and projections concerning whether they presented good investment opportunities. Through 2001, Morgan Stanley's equity research department had a system calling for rating covered companies, from most to least positive, as "Strong Buy," "Outperform," "Neutral," or "Underperform." Analyst reports were disseminated to Morgan Stanley clients by mail and facsimile and by financial advisors. Certain research reports were made available to retail clients who set up accounts on Morgan Stanley's web site and, similarly, institutional clients were able to access Morgan Stanley's research reports via accounts on Morgan Stanley's web site. In addition, certain industry reports were available on Morgan Stanley's public web site. Certain institutional clients of Morgan Stanley could also access research reports through the First Call subscription service. The financial news media on occasion also reported Morgan Stanley analysts' ratings.

9. Morgan Stanley analysts also played an important role in assessing potential investment banking transactions, in particular IPOs. Morgan Stanley's stated objective was to "take public" as lead underwriter the leading companies in their respective industry sectors and to have its research analysts serve as gatekeepers to the IPO process by investigating whether companies were appropriate IPO candidates. Research analysts who endorsed an IPO candidate typically participated in the competition to obtain the investment banking business and, if Morgan Stanley was selected as lead underwriter, helped market the IPO to institutional investors, explained the IPO to the firm's institutional and retail sales forces, and then issued research on the company.

10. Senior analysts at Morgan Stanley published individual research reports without pre-publication review by research department supervisors. While reports were reviewed for grammatical errors and for compliance with certain legal requirements, there was no system for reviewing the recommendations or price targets included in the reports of senior analysts prior to their publication.

**I. 2. THE RELATIONSHIP BETWEEN INVESTMENT BANKING AND RESEARCH  
CREATED CONFLICTS OF INTEREST FOR MORGAN STANLEY RESEARCH  
ANALYSTS**

1 11. Certain practices at Morgan Stanley created or maintained conflicts of interest for the firm's  
2 research analysts with respect to investment banking considerations. These conflicts arose from  
3 the inherent tension between the analysts' involvement in helping to win investment banking  
4 business for Morgan Stanley and their responsibilities to publish objective research that, if negative  
5 as to prospective banking clients, could prevent the firm from winning the banking business.  
6

7 **A. Morgan Stanley Marketed Research Coverage, Including, at Times, Implicitly**  
8 **Favorable Coverage, in Competing for Investment Banking Business**

9 12. Morgan Stanley typically competed with other investment banks for selection as the lead  
10 underwriter, or "bookrunner," for securities offerings, including IPOs and follow-on offerings.  
11 Significant financial rewards were at stake in these competitions. Sole or joint bookrunners  
12 generally received the largest portion of underwriting fees, which were typically divided among the  
13 participating investment banks. The bookrunner also established the allocation of shares in an  
14 offering and typically retained the greatest number of shares for itself. The typical IPO generated  
15 millions of dollars in investment banking fees for the bookrunner.

16 13. The process of selecting the lead underwriter typically culminated in a series of  
17 presentations by competing investment banks called a "bakeoff," in which investment banks  
18 competing for the business in a particular offering met with the issuer to present their qualifications  
19 and offer investment banking and other services. As part of these presentations, investment banks  
20 often provided issuers with a "pitchbook," which typically described the investment bank's  
21 credentials and services. In selecting the lead underwriters, issuers assessed a host of factors,  
22 including the strength and quality of the bankers' research coverage. Issuers sought research  
23 coverage of their stocks, believing such coverage would enhance the credibility of their businesses,  
24 potentially lead to higher stock prices, and increase their exposure to the investing public.

25 14. Between 1999 and 2001, as part of the package of services it offered to issuers to win  
26 investment banking business from certain issuers, Morgan Stanley typically committed that its

analysts would initiate (or continue) research coverage of the issuer if Morgan Stanley won the banking competition. In so doing, Morgan Stanley used its analysts as a marketing tool to help secure banking business. The promise of future research coverage was often a critical selling point that enabled Morgan Stanley to obtain millions of dollars in investment banking fees. Research coverage was part of a package of services for which Morgan Stanley was compensated in those investment banking deals.

15. Analysts played an important role in Morgan Stanley's pitches for banking business. Along with investment bankers and others, analysts were typically presented as part of the Morgan Stanley "team" that would consummate the transaction. The pitchbooks typically identified the analysts on the team and dedicated several pages to the analysts' experience, credentials, and specific role in the contemplated transaction. Analysts drafted portions of the pitchbook and almost always attended the presentations for IPO business. The pitchbooks typically compared Morgan Stanley analysts favorably to their counterparts at competing firms, citing their rankings in analyst polls and other measures.

16. Morgan Stanley typically identified its analysts as a favorable factor that issuers should consider in selecting Morgan Stanley for investment banking business. For example, in describing one reason Loudcloud, Inc., should name Morgan Stanley as bookrunner for its 1999 IPO, the pitchbook referred to two senior analysts as a "dream team" who would "articulate Loudcloud's story to investors in a way that no other investment bank can match." Another pitchbook described two senior analysts as "the most powerful combination in the extended enterprise space . . . ever."

17. In its pitches to obtain investment banking business, Morgan Stanley typically promised future research coverage as among the package of services it would provide. For example, in a pitchbook provided to iBeam Broadcasting Corp. to obtain its IPO business, Morgan Stanley said it would "provide ongoing research coverage and aftermarket trading" and, in another instance, said "coverage would be initiated immediately after the quiet period. Additional research reports will follow on a regular basis thereafter." Morgan Stanley won the iBeam IPO business and received

1 investment banking fees of approximately \$3.8 million. Another pitchbook, in a chronology of  
2 how the IPO would unfold, stated: "Research coverage initiated on day 26," which was the day  
3 research coverage could be initiated by an underwriter following an IPO. Morgan Stanley made  
4 comparable commitments to other prospective banking clients. Another Morgan Stanley  
5 pitchbook, provided to Transmeta Corp. in July 2000 in connection with its IPO, said "we view  
6 research as an ongoing commitment," and offered to "continue regular publication of research  
7 reports." Morgan Stanley won the Transmeta IPO business and received investment banking fees  
8 of approximately \$9.5 million. In other pitchbooks, Morgan Stanley emphasized its "aftermarket  
9 support" services, which it expressly described as including future research coverage. For  
10 example, a pitchbook presented to AT&T Latin America said Morgan Stanley "is committed to  
11 bolstering an IPO's performance in the aftermarket through extensive equity research and active  
12 market-making." (Emphasis added.) Morgan Stanley pitchbooks often identified the specific  
13 number of reports its analysts published on other companies, giving implicit guidance on how  
14 many reports issuers could expect to receive if they selected Morgan Stanley as lead banker.

15 18. Further, Morgan Stanley at times implicitly suggested that analysts would provide favorable  
16 research coverage, pending completion of due diligence, by noting analysts' past favorable  
17 coverage and/or emphasizing its enthusiastic support for the issuer. For example, when Morgan  
18 Stanley sought investment banking business from Convergys Corp., the company already had been  
19 covered for two years by a senior Morgan Stanley analyst who, as the pitchbook mentioned four  
20 times, considered Convergys to have been the analyst's "#1 stock pick" over those years. (During  
21 that time period, the stock price had appreciated 98%.) The May 2001 pitchbook then described  
22 the analyst as the "voice of the issuing company," who would work "in tandem" with Convergys  
23 management to position its story to investors. In the following month, June 2001, the senior  
24 analyst downgraded Convergys from Strong Buy to Outperform, still a favorable rating, then later  
25 upgraded Convergys back to Strong Buy in December 2001.

1 19. In other instances, Morgan Stanley pitchbooks identified a particular analyst's history of  
2 issuing Strong Buy or Outperform ratings on other companies. Some pitchbooks also identified  
3 instances in which other stocks covered by Morgan Stanley analysts increased in price following  
4 their IPOs. For example, the Morgan Stanley pitchbook provided to Transmeta Corp. in July 2000  
5 emphasized how one analyst's "support" of eight semiconductor IPOs since 1997 had "resulted in  
6 unparalleled performance in the public market," and included a line graph showing a dramatic  
7 increase in the stocks' price from 1998 through March 2000.

8 20. In another instance, after Loudcloud management informed Morgan Stanley in 1999 that  
9 research coverage was a key factor in its selection of the bookrunner for its IPO, Morgan Stanley's  
10 head of worldwide investment banking informed the issuer in an e-mail that the firm had  
11 "developed a successful model which combines the best of technology and telecom research at  
12 Morgan Stanley to properly position Loudcloud in the capital markets; specifically, enthusiastic  
13 sponsorship" by two research analysts who covered Loudcloud's sector. He added: "I commit to  
14 putting the entire franchise behind Loudcloud to achieve the best valuation and after market  
15 performance, as well as unmatched strategic advice post-IPO." Morgan Stanley won the  
16 Loudcloud IPO business and received investment banking fees of approximately \$4.7 million.

17 21. In addition to pitchbooks, Morgan Stanley occasionally provided draft or "mock" research  
18 reports to issuers to provide an example of how analysts might describe the issuer to investors. The  
19 draft or mock reports described the issuers in favorable terms without including ratings or price  
20 targets.

21 22. Morgan Stanley's commitments to provide research coverage were not limited to pitches  
22 for IPO business. Morgan Stanley obtained investment banking business for follow-on offerings of  
23 companies that its analysts did not cover in part by promising to initiate future coverage.

24 23. Morgan Stanley consistently honored its commitments to provide research coverage,  
25 initiating or maintaining coverage when it won the investment banking business.  
26



1 24. In Morgan Stanley's annual performance evaluation process, some analysts and bankers  
2 noted their success in obtaining banking fees by promising future research coverage. For example,  
3 in a November 3, 1999 e-mail, an investment banker listed several banking transactions that he said  
4 Morgan Stanley had won because it committed that a particular highly-rated analyst would initiate  
5 research coverage. Specifically, the banker wrote that Morgan Stanley had won two transactions  
6 totaling \$13.4 million in fees from Veritas Software Corp. "just for promising that [the senior  
7 analyst] would pick up coverage after the deals." The banker observed that this had "enraged"  
8 competing firms, which said it was "unprecedented" to give an underwriter with no previous  
9 research coverage such a high share of the fees. The banker added: "The response from the CEO  
10 to those firms -- 'you don't have [the senior analyst].'" Other analyst evaluations as well as other  
11 internal Morgan Stanley documents identified additional instances in which it was stated that  
12 Morgan Stanley won investment banking business in large part because its analysts committed to  
13 initiate coverage.

14 **B. Investment Banking Concerns Influenced Morgan Stanley's Decisions**  
15 **Whether to Initiate or Continue Research Coverage**

16 25. The decision to initiate or continue research coverage of certain companies was influenced,  
17 at least in part, by whether those companies were actual or prospective investment banking clients  
18 of Morgan Stanley.

19 26. In one instance, in May 2001, the liaison between the research and investment banking  
20 divisions was advised that a poultry company, Pilgrim's Pride, was seeking equity research  
21 coverage in connection with a prospective high-yield offering. The liaison made clear that Morgan  
22 Stanley should not commit to providing coverage until it received a certain amount of investment  
23 banking fees from the company:

24 Be careful with this one. Under no circumstances should we commit  
25 unless we get the books and at least \$3-5mm in fees, with the money  
26 in the bank before we pick up coverage. We can tell them it will go  
in the queue and we cannot promise them a rating. It costs about

1           \$1 mm to pick up coverage of a stock and there are also meaningful  
2           ongoing expenses to maintain.

3           27.       Morgan Stanley analysts on occasion also declined to cover some companies that  
4           refused to award investment banking business to Morgan Stanley. One senior analyst wrote in a  
5           2000 self-evaluation that the analyst had declined Sabre Group's requests for research coverage for  
6           four years and that the analyst had "insisted that we first be mandated on a large investment  
7           banking transaction." Generally, analysts select which of the many companies in a sector they will  
8           cover. This senior analyst did not consider Sabre to be one the analyst needed to cover, unless  
9           Morgan Stanley were to be mandated on an investment banking transaction. When Sabre provided  
10          Morgan Stanley with banking business in connection with its spin-off from AMR Corp., the analyst  
11          initiated coverage of Sabre with an Outperform rating in March 2000.

12          28.       Morgan Stanley also declined to initiate coverage of Concord/EFS, Inc. Concord  
13          initially retained Morgan Stanley as bookrunner for a 1999 secondary offering, but then hired a  
14          different bank as bookrunner after Morgan Stanley declined Concord's request that it commit to  
15          initiating coverage with a "Strong Buy" rating. Though Concord continued to offer part of that  
16          investment banking business to Morgan Stanley, Morgan Stanley withdrew, and it did not initiate  
17          research coverage of Concord at that time. In the fall of 2000, Morgan Stanley sought investment  
18          banking business from Concord in connection with another secondary offering. Concord's  
19          management told Morgan Stanley's senior analyst that it wanted an advance view of the analyst's  
20          initial rating. After completing two to three months of preliminary due diligence, the analyst told  
21          Concord that, if coverage were to be initiated at that time, the analyst tentatively would issue a  
22          "Strong Buy" up to a certain valuation level. Morgan Stanley also provided Concord with a draft  
23          research report, which, according to an e-mail written by an investment banker, was part of Morgan  
24          Stanley's "marketing efforts." When Morgan Stanley was not awarded the 2000 investment  
25          banking business, its analyst did not initiate coverage at that time, despite the analyst's initial view  
26          that Concord had emerged as a leader in its industry that preliminarily merited a "Strong Buy."

1       29.       Morgan Stanley also initiated coverage of eBay, Inc., in part with the hope of  
2 obtaining investment banking business. After Morgan Stanley initially lost the IPO business for  
3 eBay in 1998, a senior Morgan Stanley analyst met with eBay's chief executive officer and  
4 provided a draft research report on the company. After Morgan Stanley nevertheless lost the IPO  
5 business, the analyst initiated coverage on eBay on its first day of trading with an Outperform  
6 rating. The analyst was the only one covering eBay, since firms in the underwriting syndicate were  
7 prohibited from initiating coverage until after the 25-day "quiet period" had expired. It is the only  
8 time that the senior analyst initiated coverage of a company on its first day of trading. Later, in  
9 1999 and again in 2001, eBay awarded two banking transactions to Morgan Stanley, with total fees  
10 of approximately \$1.2 million. In the senior analyst's self-evaluation for 2000, the analyst stated,  
11 as part of the analyst's "philosophy" for Morgan Stanley's "Internet banking efforts," that "when  
12 we miss a winning IPO, we should work like crazy (with tons of ideas) to secure a spot as M&A  
13 advisor (USWeb/CKS) or book running manager on follow-on offerings (eBay)."

14 **C.       Morgan Stanley Research Analysts Performed Investment Banking**  
15 **Functions**

16       30. Morgan Stanley research analysts performed a number of investment banking-related  
17 functions. They identified potential IPO and merger and acquisition transaction candidates for the  
18 investment banking department, participated in soliciting investment banking business for the firm,  
19 and participated in road shows and other efforts to sell Morgan Stanley-underwritten IPOs and  
20 secondary offerings to institutional investors. At times, analysts also had discussions about  
21 business strategy with investment banking clients directly, and one senior analyst was described as  
22 a relationship manager with certain investment banking clients.

23       31. Morgan Stanley kept a record of each analyst's contribution to investment banking  
24 revenues. Each year, a "Revenue Share Analysis" was prepared that listed every investment  
25 banking transaction in which each analyst had participated, the revenues from each transaction, a  
26 rating on a scale of 1 to 5 (5 being "critical" to the deal) of the analyst's contribution to the

1 transaction, and a calculation of the analyst's "share" of the credit for the revenues secured from  
2 the transaction. The Revenue Share Analysis also recorded investment gains on Morgan Stanley  
3 investments in companies covered by the analyst.

4 32. One senior analyst's involvement in investment banking activities was such that several  
5 investment bankers at the firm regarded the analyst as tantamount to an investment banker. One  
6 banker wrote that the analyst was the most committed and focused banker with whom he had ever  
7 worked. Another wrote that the analyst was a "commercial animal" who would do anything  
8 appropriate to win underwriting mandates. The analyst's supervisor wrote in 1999 that the  
9 analyst's focus was primarily on banking and that, notwithstanding the growing demand for the  
10 analyst's time on investment banking matters, the analyst needed to devote more attention to  
11 institutional investors and the firm's institutional sales force.

12 33. The analyst's own self-evaluation prominently mentioned the analyst's assistance to  
13 investment banking in selecting and generating investment banking business and large fees, stating:  
14 "Bottom line, my highest and best use is to help MSDW win the best Internet IPO mandates (and  
15 to ensure that we have the appropriate analysts and bankers to serve the companies well). . . "  
16 (emphasis in original). It also prominently listed the deals and revenues from the analyst's  
17 investment-banking connected efforts:

18 **Internet Investment Banking, a Record Year with \$205MM+**  
19 **YTD Revenue, [20+] Pending Financings, Co-Coverage**  
20 **(Leverage) in 85% of Cases, 6 of 6 Tech IBD Revenue**  
21 **Generating Clients, Internet Category was #1 Revenue**  
22 **Generator in Tech IBD (\$505MM YTD Tech Revenue). . .**  
23 (Emphasis in original.)

24 OK, the numbers (see Attachment A): Forty investment banking  
25 transactions (\$143MM in fees) . . .

26 It's notable that 96% of the \$205MM in revenue was derived from  
clients new to the firm since 1995! Exceptions were America Online,  
Compaq, Hearst and Sotheby's. And I have been very involved in  
this business. (Emphasis added.)

1 **D. Investment Banking Was an Important Factor in Determining Research**  
2 **Analysts' Compensation**

3 34. From 1999 through 2001, participation in investment banking activities was a factor in  
4 determining the total compensation awarded to some Morgan Stanley research analysts. These  
5 analysts thus faced a conflict of interest between helping win investment banking business for  
6 Morgan Stanley and publishing negative research that could prevent Morgan Stanley from winning  
7 that banking business.

8 35. The annual salaries paid to senior Morgan Stanley analysts and other senior Morgan  
9 Stanley personnel typically were comparatively small components of their total annual  
10 compensation. The majority of their total annual compensation was paid in the form of a bonus. In  
11 2000, one senior analyst received a year-end bonus that was 90 times greater than the analyst's  
12 base salary.

13 36. The total compensation paid to analysts was based in part on Morgan Stanley's total  
14 revenues for a particular year, including the investment banking fees that Morgan Stanley received.  
15 Thus, the success or failure of the investment banking division determined, in part, the total amount  
16 of funds available to pay employee compensation in any given year, including analyst  
17 compensation.

18 **1. Analysts Rated Their Contributions to Investment Banking**

19 37. The level of contribution to investment banking transactions was an important factor in the  
20 annual evaluations of Morgan Stanley's analysts and compensation decisions.

21 38. As part of the annual performance evaluation process, analysts were asked to submit self-  
22 evaluations that, among other things, discussed their contributions to Morgan Stanley. Analysts  
23 often included in their self-evaluations a discussion of their involvement in investment banking,  
24 including a description of specific transactions, the fees generated, and the role the analyst played  
25 in each deal. For example, one-quarter of the 1999 self-evaluation of one analyst was dedicated to  
26

the analyst's role in investment banking activities, and identified forty transactions that year that had generated a total of \$143 million in fees.

39. As part of the evaluation process, the analysts also provided a rating of their contributions to specific banking transactions. Analysts were instructed to complete a Transaction Summary Worksheet ("TSW") in which they graded their roles in specific deals on a scale of 1-5.

Instructions provided to each analyst described the rating system as follows:

- 5 = critical to deal
- 4 = important to development and execution
- 3 = solid contribution
- 2 = limited contribution
- 1 = contribution limited to providing research coverage

40. Analysts were also instructed to comment on important aspects of any transaction, including, for example, whether the "promise of coverage was critical to winning" the mandate. The instructions informed analysts that supplying the information called for in the TSWs was an "important part" of their annual evaluation process.

## **2. Investment Bankers Evaluated Analysts' Performance**

41. Morgan Stanley also solicited and received the investment bankers' assessment of the analysts' performance on the same transactions. Morgan Stanley's liaison between the research and investment banking divisions compiled and summarized the bankers' evaluations of the analysts' role in each deal and then prepared a final TSW listing for each transaction that provided a joint evaluation of the analysts' contributions to each deal.

42. Finally, as part of Morgan Stanley's "360 degree" review process, in which employees confidentially reviewed one another, investment bankers submitted written opinions of analysts with whom they worked.

43. Investment bankers thus played a role in the annual evaluation of research analysts by providing substantive information that was considered in the year-end evaluation process and input into the determination of the analysts' compensation for that year. The investment bankers' role in the evaluation process created a conflict of interest for analysts, who hoped for positive evaluations

1 from investment bankers at the same time that they were charged with issuing objective research  
2 reports that, if negative, could have impeded Morgan Stanley's ability to win future investment  
3 banking business from the covered companies.

4       **3.       Investment Banking Was the Factor Accorded the Greatest**  
5       **Weight by Management in Reviewing Management's Initial**  
6       **Determination of Proposed Analysts' Compensation**

7       44. In 1999 and 2000, analyst compensation was set primarily by a managing director in the  
8 equity research division. The managing director made an initial determination of proposed  
9 compensation for all analysts and ranked the analysts based on that determination. The managing  
10 director then ranked the analysts based on their composite scores in nine categories. The managing  
11 director then compared the two rankings before forwarding the compensation recommendations to  
12 superiors.

13       45. The nine categories used to rank the analysts included the amount of investment banking  
14 revenues attributed to analysts based on their involvement in transactions (relative weight of 33%)  
15 and eight other categories related to core research activities, including: (1) poll rankings from the  
16 *Institutional Investor* and other sources (19%); (2) poll ranking from institutional equity division  
17 sales (12%); (3) firm activities and ability to be a team player (11%); (4) the "hit ratio" in vote  
18 gathering from institutional clients (7%); (5) rank in vote gathering from institutional clients (7%);  
19 (6) stock picking (active portfolio vs. passive portfolio) (6%); (7) stock picking (active portfolio vs.  
20 index portfolio) (3%); and (8) poll ranking from retail sales (2%). Thus, the managing director  
21 assigned a one-third weight to investment banking revenues -- the highest weight given to any  
22 single category.

23       46. The impact that an analyst's contribution to investment banking revenues could have on the  
24 determination of the analyst's compensation is shown by the compensation of one Morgan Stanley  
25 senior analyst in 1999 and 2000. In 1999, the analyst who received the highest compensation  
26 among Morgan Stanley research analysts had a composite score that ranked only 11<sup>th</sup> overall, but  
ranked first in investment banking revenues.

1 47. In 2000, the same analyst continued to rank first in investment banking revenues: the total  
2 investment banking revenues that the analyst helped Morgan Stanley obtain more than doubled. In  
3 most other categories, however, the analyst's performance declined from 1999, and the analyst's  
4 composite score dropped to 19th overall. In 2000, the analyst ranked only 70th out of 111 analysts  
5 in stock picking, and the analyst's self-evaluation conceded that 2000 had been the analyst's worst  
6 stock-picking year in fifteen years. Nevertheless, this analyst's total salary and bonus for 2000  
7 increased by approximately \$8.7 million as compared to 1999, again ranking first among all  
8 Morgan Stanley analysts.

9 **I. 3. MORGAN STANLEY DID NOT DISCLOSE THAT IT PAID**  
10 **\$2.7 MILLION OF UNDERWRITING FEES AT ISSUERS' DIRECTION TO**  
11 **OTHER INVESTMENT BANKS TO PROVIDE RESEARCH COVERAGE**

12 48. In at least twelve stock offerings in which it was selected as lead underwriter from 1999  
13 through 2001, Morgan Stanley paid \$2.7 million of the underwriting fees to approximately twenty-  
14 five investment banks. Internal Morgan Stanley documents described these payments as "research  
15 guarantees" or "guaranteed economics for research." Other internal Morgan Stanley documents  
16 noted instances in which the bank receiving the payment "will write." Morgan Stanley made these  
17 payments from the offering proceeds at the direction of the issuers.

18 49. These "research guarantee" payments included more than \$670,000 paid to three  
19 investment banks in connection with an offering by Veritas Software Corp. in December 1999;  
20 more than \$816,000 paid to seven banks in connection with an Agile Software Corp. offering in  
21 December 1999; and more than \$440,000 paid to five banks in connection with an offering by  
22 Atmel Corp. in February 2000. The individual disbursements ranged from two payments of just  
23 over \$6,000 each to three payments of more than \$225,000 each.

24 50. The issuers' registration statements and other offering documents identified the other banks  
25 as part of the underwriting syndicates and as receiving payments, but did not specifically disclose  
26 the payments as being for research. Morgan Stanley did not take steps to ensure that these banks



disclosed these payments in their research reports. Morgan Stanley also did not cause the payments to be disclosed in offering documents or elsewhere as having been for research.

**I. 4. MORGAN STANLEY FAILED REASONABLY TO SUPERVISE ITS SENIOR RESEARCH ANALYSTS**

**A. Morgan Stanley Had No System for Reviewing the Ratings Issued by Its Senior Analysts**

51. Morgan Stanley failed reasonably to supervise its senior research analysts. The firm required only non-officer-level analysts to submit their initial ratings and proposed changes in ratings for review by the Stock Selection Committee. Senior analysts -- principals and managing directors -- were not subject to this requirement. In addition, Morgan Stanley had no effective system in place for reviewing the ratings of its senior analysts against changed conditions.

52. Morgan Stanley's lack of an effective review system allowed some principal and managing director analysts to maintain Outperform ratings unchanged on declining stocks without any review by management. For example, in 2000 and 2001, four senior analysts maintained Outperform ratings unchanged on 13 stocks as the prices of the stocks declined by over 74 percent. The names of the stocks, their percentage declines, and the number of months without a change in the Outperform rating are shown on the following chart:

Company	Percent Price Drop While Rated Outperform	Months Without Change in Outperform Rating
Chemdex (Ventro)	96.2	8.5
Drugstore.com	95.4	30
Priceline.com	92.0	30
Ask Jeeves	90.9	16
Marimba	88.9	8.5
Homestore.com	88.7	10
Vignette	87.1	7.5
VeriSign	83.3	19.5
Akamai	82.8	10
Women.com	80.3	8.5
CNET	77.7	16.5
Inktomi	76.9	15
FreeMarkets	74.3	23

53. Not until late 2001, after complaints from Institutional Sales persons made as part of the year-end evaluation process, did management state to one of the analysts: "Don't let your ratings get stale; change them ahead of expected price action."

**B. Morgan Stanley's Analysts Virtually Never Used the Lowest Rating in the Firm's Stock Rating System**

54. From 1995 to March 2002, Morgan Stanley publicly stated that it had a four-category rating system: Strong Buy; Outperform; Neutral; and Underperform. "Underperform" was defined as follows: "Given the current price, these securities are not expected to perform as well as other stocks in the universe covered by the analyst." Although Morgan Stanley stated that it had a four-category system, its analysts virtually never used the "Underperform" rating and, in effect, used a three-category system. From 1999 through 2001, the firm published research on approximately 1,000 North American company stocks. No more than three of the 1033 stocks covered over the course of 1999 were given an Underperform rating; no more than five of the 1058 stocks covered over the course of 2000 received that rating; and no more than six of the 1030 stocks covered over the course of 2001 were rated Underperform.

55. Morgan Stanley management was aware that analysts were not using the "Underperform" rating, but did not correct the problem until March 2002, when a new rating system was instituted.

**II.**

**CONCLUSIONS OF LAW**

1. The District of Columbia Department of Insurance and Securities Regulation has jurisdiction over this matter pursuant to D.C. Official Code § 31-5606.01 (2001 Ed.).

2. The Commissioner of the Department of Insurance and Securities Regulation finds that Morgan Stanley violated D.C. Official Code § 31-5602.07(a)(9), (12) in that:

a) The relationship between investment banking and research created conflicts of interest for Morgan Stanley research analysts;

b) Morgan Stanley did not disclose that it paid \$2.7 million of underwriting fees at issuers' direction to other investment banks to provide research coverage; and

3. The Commissioner of the Department of Insurance and Securities Regulation finds the following relief appropriate and in the public interest.

## ORDER

IT IS HEREBY ORDERED:

2. Morgan Stanley will CEASE AND DESIST from violating D.C. Official Code § 31-5602.07(a)(9), (12) and will comply with D.C. Official Code § 31-5602.07(a)(9), (12) in connection with the research practices referenced in this Order and will comply with the undertakings of Addendum A, incorporated herein by reference.

3. As a result of the Findings of Fact and Conclusions of Law contained in this Order, Morgan Stanley shall pay a total amount of \$125,000,000.00. This total amount shall be paid as specified in the SEC Final Judgment as follows:

a. \$25,000,000 to the states (50 states, plus the District of Columbia and Puerto Rico)

(Morgan Stanley's offer to the state securities regulators hereinafter shall be called the

1 “state settlement offer”). Upon execution of this Order, Morgan Stanley shall pay the sum  
2 of \$ 250,000 of this amount to Department of Insurance and Securities Regulation as a civil  
3 monetary penalty pursuant to D.C. Official Code § 31-5606.02(b)(4), to be deposited in the  
4 District of Columbia’s GENERAL FUND, made payable to the ‘D.C. Treasurer’, pursuant  
5 to D.C. Official Code § 1-204.50. The total amount to be paid by Morgan Stanley to state  
6 securities regulators pursuant to the state settlement offer may be reduced due to the  
7 decision of any state securities regulator not to accept the state settlement offer. In the  
8 event another state securities regulator determines not to accept Morgan Stanley’s state  
9 settlement offer, the total amount of the District of Columbia payment shall not be affected,  
10 and shall remain at \$250,000;

11 b. \$25,000,000 as disgorgement of commissions, fees and other monies as specified in the  
12 SEC Final Judgment;

13 c. \$75,000,000, to be used for the procurement of independent research, as described in the  
14 SEC Final Judgment;

15 4. If payment is not made by Morgan Stanley or if Morgan Stanley defaults in any of its  
16 obligations set forth in this Order, the Commissioner of the Department of Insurance and Securities  
17 Regulation may vacate this Order, at its sole discretion, upon 10 days notice to Morgan Stanley and  
18 without opportunity for administrative hearing.

19 5. Morgan Stanley agrees that it shall not seek or accept, directly or indirectly, reimbursement  
20 or indemnification, including but not limited to payment made pursuant to any insurance policy,  
21 with regard to all penalty amounts that Morgan Stanley shall pay pursuant to this Order or section  
22 II of the SEC Final Judgment, regardless of whether such penalty amounts or any part thereof are  
23 added to the Distribution Fund Account referred to in the SEC Final Judgment or otherwise used  
24 for the benefit of investors. Morgan Stanley further agrees that it shall not claim, assert, or apply  
25 for a tax deduction or tax credit with regard to any state, federal or local tax for any penalty  
26 amounts that Morgan Stanley shall pay pursuant to this Order or section II of the SEC Final

Judgment, regardless of whether such penalty amounts or any part thereof are added to the Distribution Fund Account referred to in the SEC Final Judgment or otherwise used for the benefit of investors. Morgan Stanley understands and acknowledges that these provisions are not intended to imply that the Commissioner of the Department of Insurance and Securities Regulation would agree that any other amounts Morgan Stanley shall pay pursuant to the SEC Final Judgment may be reimbursed or indemnified (whether pursuant to an insurance policy or otherwise) under applicable law or may be the basis for any tax deduction or tax credit with regard to any state, federal or local tax.

6. This Order is not intended by the Commissioner of the Department of Insurance and Securities Regulation to subject any Covered Person to any disqualifications under the laws of any state, the District of Columbia or Puerto Rico (collectively, "State"), including, without limitation, any disqualifications from relying upon the State registration exemptions or State safe harbor provisions. "Covered Person" means Morgan Stanley, or any of its officers, directors, affiliates, current or former employees, or other persons that would otherwise be disqualified as a result of the Orders (as defined below).

7. The SEC Final Judgment, the NYSE Stipulation and Consent, the NASD Letter of Acceptance, Waiver and Consent, this Order and the order of any other State in related proceedings against Morgan Stanley (collectively, the "Orders") shall not disqualify any Covered Person from any business that they otherwise are qualified, licensed or permitted to perform under the applicable law of the District of Columbia and any disqualifications from relying upon this state's registration exemptions or safe harbor provisions that arise from the Orders are hereby waived.

8. The Orders shall not disqualify any Covered Person from any business that they otherwise are qualified, licensed or permitted to perform under applicable state law.

9. For any person or entity not a party to this Order, this Order does not limit or create any private rights or remedies against Morgan Stanley including, without limitation, the use of any e-mails or other documents of Morgan Stanley or of others regarding research practices, or limit or create

1 liability of Morgan Stanley, or limit or create defenses of Morgan Stanley to any claims.

2 10. Nothing herein shall preclude the District of Columbia, its departments, agencies, boards,  
3 commissions, authorities, political subdivisions and corporations, other than the Department of  
4 Insurance and Securities Regulation and only to the extent set forth in paragraph 1 above,  
5 (collectively, "State Entities") and the officers, agents or employees of State Entities from asserting  
6 any claims, causes of action, or applications for compensatory, nominal and/or punitive damages,  
7 administrative, civil, criminal, or injunctive relief against Morgan Stanley in connection with  
8 certain research practices at Morgan Stanley.

9 Dated this 25 day of Nov, 2003.

11 IN WITNESS WHEREOF, I have hereunto set my  
12 hand and affixed the official seal of this Department at  
13 the City of Washington, D.C., this 25 day of Nov, 2003

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15 LAWRENCE H. MIREL, Commissioner  
16 Department of Insurance and Securities Regulation  
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